Differences between management accounting and financial accounting

Business, Management

Accounting is concerned with providing both financial and non-financial information that will help decision makers to make good decisions. An understanding of accounting therefore requires an understanding of the decision making process and an awareness of the users of accounting information. The major purposes of accounting are to formulate overall strategies and long-run plans. Resource allocation decisions such as product, pricing and customer emphasis. Cost planning and control of activities. The measuring of the performance of the company.[1]

The managing director at ABX Co does not understand the difference between financial accounting and management accounting; and therefore is finding it hard to understand why I have proposed the idea of having an assistant to concentrate on management accounting duties. I will be discussing below various elements as to what and how financial accounting and management accounting differ.

Differences between Financial accounting & Management accounting

Financial accounting and Management accounting both produce reports and statements, but it is to whom and when they start to differ. I will be discussing below the major differences between the two branches of accounting which are legal requirements, the focus of segments of the business, the accepted accounting principles and report frequency.

Management accounting is concerned with the provisions and use of accounting information to managers within organizations, to provide them with the basis to make informed business decisions that will allow them to be

better equipped in their management and control functions. Management accounting data is only accessed and used by those internal to the business.[2]

Financial accounting is the field of accountancy concerned with the preparation of financial statements for decision makers, such as stockholders, suppliers, banks, employees, government agencies, owners, and other stakeholders.[3]

Legal Requirements: There is a statutory requirement for public limited companies to produce annual financial accounts regardless whether or not management regards this information as useful. Management accounting is entirely optional and information should be produced only if it is considered that the benefits from the use of the information by management.[4]

Focus of segments of the business: Financial accounting reports describe the whole of the business; whereas management accounting focuses on small parts of the organisation, for example the cost and profitability of products and departments.[5]

The accepted accounting principles: Financial accounting statements must be prepared to conform to the legal requirements and the generally accepted accounting principles established by regulatory bodies such as the Financial Reporting Council (FRC).[6] However, Management accountants are not regulated by any specific regulatory bodies when providing managerial information. This is because the information and reports produced by management accountants are for internal use only within the organisation.

The reports are not published for public use; in contrast, financial statements are prepared for stockholders, suppliers, banks, employees, government agencies, owners, and other stakeholders.

Report frequency: Financial accounting reports on what has happened in the past in an organisation, whereas management accounting is concerned with future information as well as the past information. Financial accounting statements are published annually and less detailed statements are published semi-annually. It is a minimum requirement for an organisation to produce financial statements annually.

Managers require information quickly if it is to act on it. Management accounting reports on various activities and may be prepared at daily, weekly or monthly intervals. [7]

Functions of Management Accounting

Management accountants contribute to the company's decisions about strategy, planning, and control, by scorekeeping, attention directing and problem solving.[8]

Scorekeeping: It refers to the accumulation of data and the reporting of reliable results to all levels of management. Examples of scorekeeping are the recording of actual revenues and purchases relative to budgeted amounts.[9]

Attention Directing: Helping managers focus on opportunities and problems. Attention directing means getting managers to focus on all opportunities that

would add value to the company and not to focus only on cost reduction opportunities. An example is highlighting rapidly growing markets where the company may be under funding its investment. [10]

Problem Solving: It refers to the comparative analysis undertaken to identify the best alternatives in relation to the organisation's goals. An example is comparing the financial advantages of leasing a fleet of motorcycles rather than owning those motorcycles.[11]

Different decisions place different emphasis on these three roles. For strategic decisions and planning decisions, the problem solving role is most prominent. For control decisions (which include both actions to implement planning decisions and decisions about performance evaluation), the scorekeeping and attention keeping and attention directing roles are most prominent because they provide feedback to managers. Feedback from scorekeeping and attention directing often leads to revise planning decisions and some times make new strategic decisions. Information that prompts a planning decision is frequently reanalyzed and supplemented by the management accountant in the problem-solving role. The ongoing interaction among strategic decisions, planning decisions, and control decisions means that management accountants often are simultaneously doing problem solving, scorekeeping and attention directing activities.[12]

The Management Accountant's Role

Managers implement strategy by translating it into actions. Managers do this using planning systems and control systems designed to help the collective

decisions throughout the organisation. Management accountants play an active role in linking control to future planning.[13]

A management accountant will be able to complete many tasks and services at ABX co. One of these tasks would be to produce a break-even analysis. Break-even analysis uses fixed costs and variable costs to calculate the break-even point. The breakeven point for a firm is when total costs equals to total revenue. Expenditure and income are the same and the firm makes neither a profit nor a loss. If the firm can sell at production levels above this point, it will be making a profit. If sales fall below this point, it will be making a loss. Establishing the breakeven point helps a firm to plan the levels of production it needs to be profitable. Before you can calculate the breakeven point, you need to identify the firm's costs.[14] These include:

Fixed Costs

A fixed cost is one which is not affected by changes in the level of activity, for a specified period of time. Total fixed costs are constant for all levels of activity whereas unit fixed costs decrease proportionally with the level of activity.[15] Examples of fixed costs:

- Rent and rates - Depreciation - Research and development - Marketing costs (non- revenue related) - Administration costs [16]

Variable Costs

Variable costs are those costs which vary in direct proportion to the volume of activity, that is, doubling the level of activity will double the total variable

cost. Consequently, total variable costs are linear and unit variable cost is constant. Examples of variable costs:

- Materials used to manufacture a unit of output or to provide a type of service - Labour costs of manufacturing a unit of output or providing a type of service - Commission paid to a sales person. [17]

Semi-variable Costs

A semi-variable cost is one which varies, however not in a direct proportion, with changes in the level of activity, over a defined period of time. It includes both a fixed element that is fixed whatever the level of activity and a variable component that is directly related to the level of activity. Examples of Semi-variable Costs:

- Office salaries where there is a core of long term secretarial staff plus employment of temporary staff when activity levels rise - Maintenance charges where there is a fixed basic charge per year plus a variable element depending on the number of call-outs per year. [18]

The Break-Even Chart The analysis of a breakeven chart considers whether a venture runs at a profit or a loss. Sales above the breakeven point indicate continued and profitable growth. The principle of break-even theory is that during the early stages of a business venture, total costs, both fixed and variable, exceed sales. As output increases, sales begin to rise faster than costs and, eventually, they become equal (breakeven point). If sales continue to rise and exceed total costs, the business achieves profitability.

The tool assumes that all the goods which are produced will be sold and that costs, namely the price, will remain constant.

Likewise, it also relies on the capacity in terms of output to remain unchanged. Breakeven charts are universally applied to simply and graphically illustrate and forecast a company's projected revenue, and to calculate the time for profitability to be reached. It is used by financial and marketing strategists to predict the effect that changes in price will have on the percentage change in sales over time. It is also a useful tool to analyse the relationship between fixed and variable costs and to predict the effect on profitability of changes to those costs.[20]